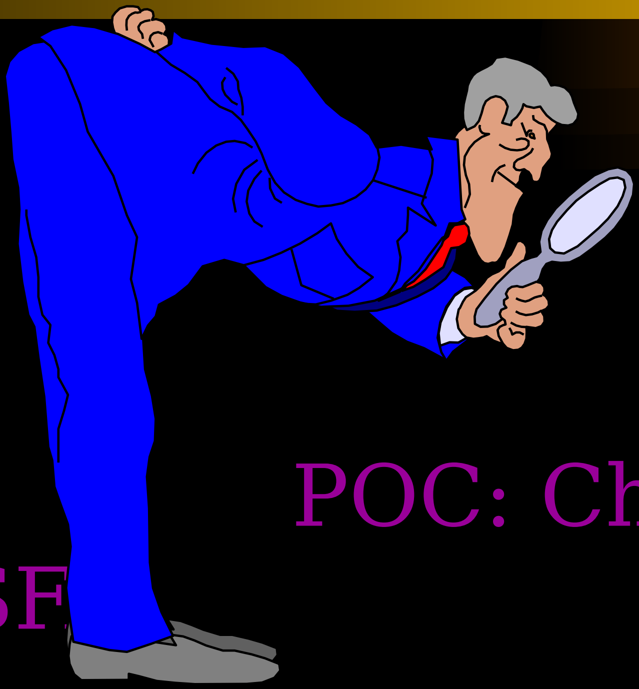
Monitoring FPRAs



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Monitoring FPRAs

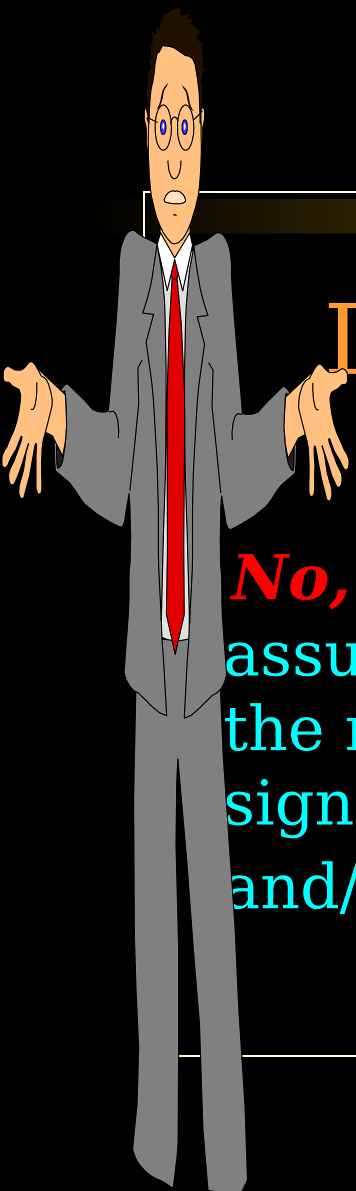
Why Bother?

Monitoring FPRAs

The Need

Change is inevitable, whether it occurs in the general business environment, or specific to a company's localized climate. Changes may appear seemingly suddenly, as with mergers, or more gradually as the aggregate accretion of time's relentless forward motion. Regardless of type, change may affect the validity of any existing FPRA. However, without monitoring costs incurred as an accounting period progresses, ACOs have no reliable, consistent, and continuous way to determine if a given FPRA remains valid, in total or in part.

Monitoring FPRAs



Does That Mean Any Type of Change?

No, only changes that affect the underlying assumptions and variables used in developing the rates. In other words, changes that significantly impact the projected expense pools and/or allocation bases, and thereby the rates.

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What Risk Do I Place The Government by Not Monitoring?

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The Risk

The risk to the government is measured by the amount of the windfall profits, or the interest associated with premature payments, or the shortfall in funding under each affected contract.

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The Risk

For example,under ***firm fixed priced*** contracts, the government absorbs increased costs over what it should have paid or will pay when the actual rates are lower than the negotiated rates. The difference between the two then becomes a windfall profit to the contractor. Premature overpayment may result also under firm fixed priced contracts, even if overstated rates were not used to definitize the contract, but are used to calculate the progress payments. On the other hand, understated rates will result in a loss for the contractor, and if material enough, one less government supplier.

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The Risk

Under *reimbursable contracts* when the rates are understated for definitization, cost overruns and funding shortfalls may result. On the other hand, premature overpayment may result from overstated rates, even if those rates were not used to definitize the contract, when the said rates are used to pay cost vouchers. Additionally, overstated rates used to develop NTEs may create surpluses that with time transmute into canceling funds. That is to say funds that should have been available to be used productively elsewhere.

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Changes

So What Kind of Changing Conditions Must I Be Alert To?

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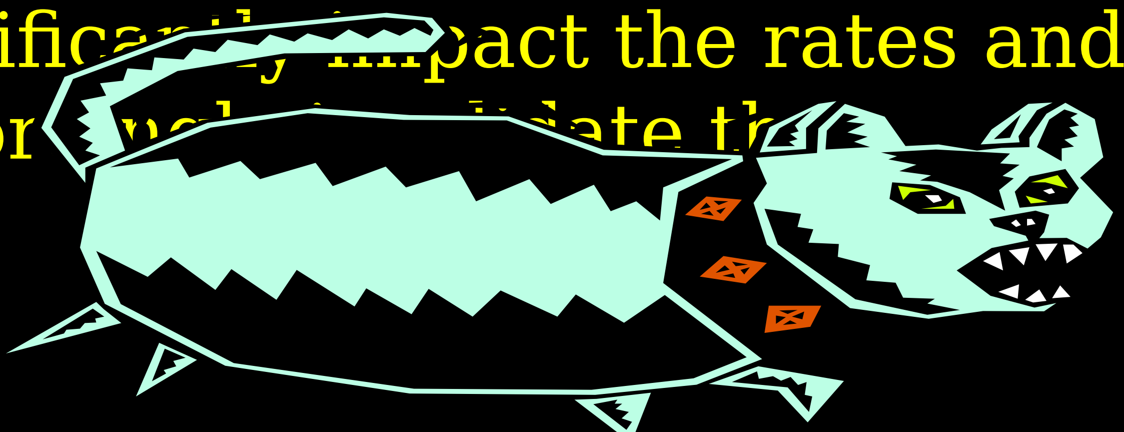

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Typical Types of Changes

- *Allocation Bases Increase:* **Increased bases result from growing revenues or output, which in turn translate into lower rates usually due to the receipt of more and/or larger dollar valued contracts to carry or amortize the indirect expenses over. In addition to augmenting sales through effective customer outreach, this situation also may occur when a company increases its offerings such as through the purchase or development of new, enhanced or expanded product lines. Also, this may appear to happen suddenly as through acquisition of or merger with another company.**

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Typical Types of Changes

- ***Allocation Bases Decrease:*** **Decreased bases result from reduced revenues, which translate into higher rates usually due to fewer contracts and/or overall dollars to carry the indirect expenses or costs of doing business. That is to say the value of the output has fallen. Typically this is a reflection of declining sales, although it simply may reflect reduced output. However, this situation also may arise when significant programs have been terminated or are nearing completion. Likewise, it may reflect downsizing and other newly implemented efficiencies, such as adopting more cost effective processes or engineering breakthroughs affecting direct costs.**

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Typical Types of Changes

- *Expense Pools Increase or Decrease:*
  Increases in the indirect expense pools that are disproportionately greater than concurrent increases in the bases, if any, translate into higher rates. Conversely, similar decreases result in reduced rates. The causes are diverse such as: adopting more efficient practices, or lapsing into less efficient ones; hiring indirect workers, or laying them off; adding functions or processes to a pool, or eliminating them; and, increasing the ratio of supervisors or support labor/engineers to the direct workforce, or decreasing that ratio.

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Typical Types of Changes

Accounting Changes: **While CAS 9903.302-2 provides a definition for that specific context, many types of changes to a contractor's accounting system may significantly impact the projected rates, although not necessarily so. The impact on a given rate may be upward,**

downward, or immaterial.

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Typical Types of Changes

Accounting Changes: **Often such changes shift expenses between direct and indirect cost classifications, or between the indirect expense pools themselves, thereby, invalidating the rates. While at the top level the shifts may appear to be "a wash," attention should be directed at the effect of the changes, as well as the ramifications of the continued usage of the existing FPRA, on government versus commercial contracts, cash rich versus cash poor programs, as well as on programs between federal agencies. Changes may be initiated simply by the desire to have the accounting system better reflect and capture actual and desired business practices and activity. On the other hand, some contractors see it as an opportunity to have the government subsidize its commercial sector.**

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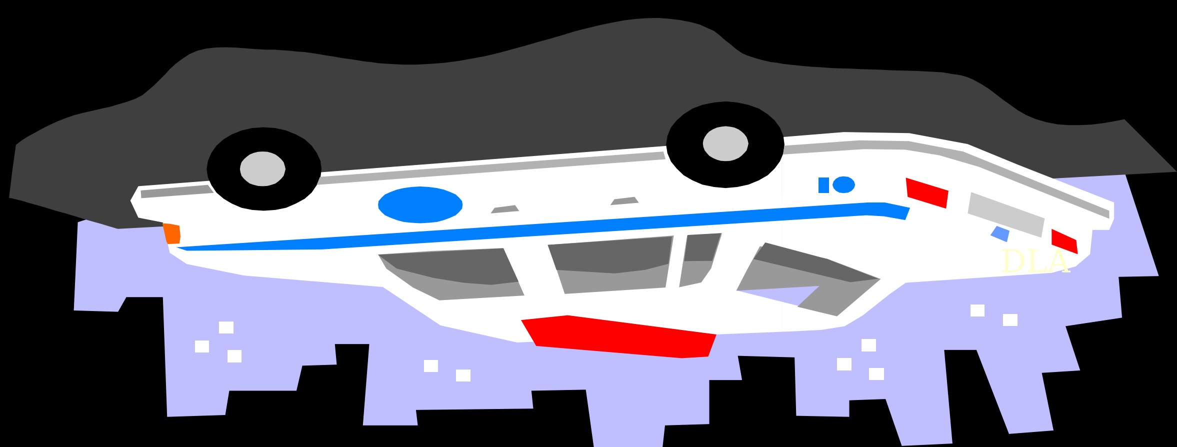
So Other Than Good Business Sense, What Compels Us To Monitor FPRAs?



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REGULATORY GUIDANCE

FAR 42.1701 states, “When an FPRA is invalid, the contractor should submit and negotiate a new proposal to reflect the changed conditions.”

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How To Determine An Invalid FPRA?

FAR 42.1701 further states that the FPRA shall address the "… data requirements for systemic monitoring to ensure the validity of the rates."

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What Can We Do If The Rates Are Invalid?

FAR 42.1701 **goes on to provide the tools required to contractually safeguard and remedy the situation by mandating that FPRAs include "...specific terms and conditions covering expiration, application..." Additionally, it mandates inclusion of provisions, "... for cancellation at the option of either party...," and requires, "...the contractor to submit to the ACO and to the cognizant auditor any significant change in cost and pricing data."**

Monitoring FPRAs

Who Is Responsible To Monitor FPRAs?

Monitoring FPRAs

Responsibility

The One Book tasks the ***ACO*** with monitoring FPRAs in order to ascertain validity. However, a ***Price Analyst or other designated technical specialist*** should track and assess actual overhead and labor costs against the FPRAs, including against the corresponding operating budgets and projections.

Monitoring FPRAs

How?

- Identify significant high-dollar-volume and/or sensitive cost indicators for tracking.
- Compare actual expenditures with projected expenditures by individual cost elements, i.e., headcount, business volume, base hours, relationships between pools and bases, direct labor costs per hour by category.
- Perform variance analysis to identify and understand differences between actual and projected expenditures.

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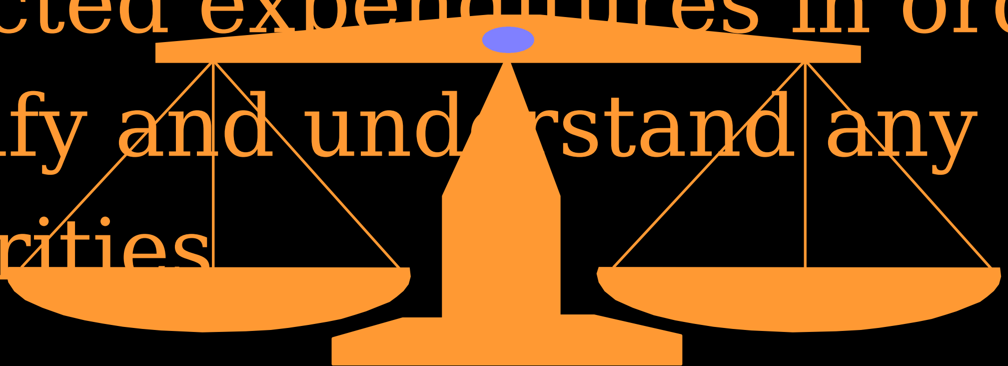
What Is Variance Analysis?

Again, merely a comparison of costs between the actual and projected expenditures in order to identify and understand any disparities



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VARIANCE ANALYSIS

Where Does The Data Comes From?

The contractor shall provide the *actuals* on a regular basis and at the level of detail as delineated by the provisions of the FPRA itself.

versus

The *projected expenditures* should in aggregate be the negotiated rates. However, for the particulars, including the constituent build-up of the pools and bases, the key drivers and indicators, the period costs, the variable costs, the underlying assumptions, the work papers, the contractor's proposal, and the data relied upon, the PNOs/PNMs should be the single point of reference.

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Variance Analysis

Scenario: After three months of actuals have been collected for an accounting period, the analyst notes that the direct labor costs for an offsite rate are running well below projections, by 8.0%, while the actual direct engineering costs are 12.0% above projections. Should the ACO be concerned?

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Variance Analysis

The answer depends on the materiality of the variance, as well as the explanation for it. The One Book states that, “Any variance which materially affects rates must be analyzed by the ACO and explained by the contractor.”

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Variance Analysis

The One Book goes on to say that generally "… variances of cost elements, where the baseline targets and actual expenditures are out of tolerance by both three percent and $100,000, should be analyzed in depth. When unjustified variances are identified and the contractor fails to take corrective action, the ACO must cancel the FPRA, or the affected portion of the FPRA, and issue a FPRR."

Monitoring FPRAs

Variance Analysis

What about our example? **While the amount of variance may in itself be significant, assuming a straight line or linear progression, the apparent disparity may have been expected, and will correct itself as the year continues. For instance, if that offsite facility is anticipated to go from a developmental phase into a full production mode during the second quarter of the year, the FPRA may yet be valid. However, if critical engineering obstacles remain precluding a timely and smooth transition, probably not so. Likewise, if the contractor has re-classified many functions from direct to indirect, or the converse, thereby obviating original FPRA assumptions, than again probably not so. The specifics of each case must be evaluated.**

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DOCUMENTATION

Assessment

Remember to document the files evidencing that the variance analysis has been performed, as well as all other techniques employed. This means that where there are no concerns, documentation should be adequate to support this determination. If the variance falls within the three percent, $100,000 rule, documentation should identify cause and discuss probable effect, including whether or not there is reason for concern and the proposed corrective action to be taken, if any.

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DOCUMENTATION

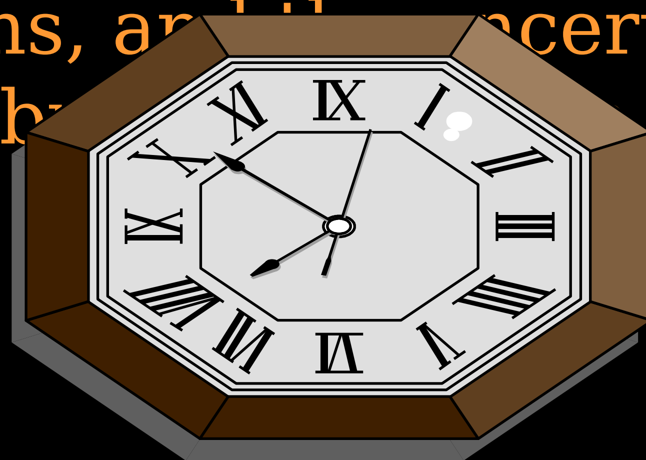
ASSESSMENT

Further, there should be a written plan for monitoring the FPRA. This plan should list responsibilities for the tracking and assessment activities. Also, it should address procedures for timely correction of unjustified variances. As a suggestion, prepare it as an attachment to the proposed FPRA exhibit in the PNM. By doing so, it can serve to support the depth and frequency of the reporting requirements as set forth in the agreement, while securing higher level concurrence concerning the delegation of technical responsibilities associated with tracking and assessment.

Monitoring FPRAs

Reports

How often should you require the contractor to submit them? As often as you deem necessary to protect the government's interests, whether it be monthly, bimonthly, or quarterly. Considerations should include the dollars at risk, the volatility of the assumptions, an ncertainties within the b



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Reports

Frequency

Caveat: **Be aware that if the frequency for requiring the data is too lengthy between submissions, it may take a substantial portion of a year, if not most of it, before an agreement can be cancelled, should that be determined appropriate. For example, if you require reports quarterly, it may take up to almost half a year to cancel the FPRA: 3 months to the end of the quarter, another 30 days to collect the actuals before the ACO receives the report, plus another 30 days within which to analyze, discuss, and cancel the FPRA.**

Monitoring FPRAs

Reports

Depth of Detail and Format

What level of detail is required? The level of detail should be dictated by the degree of visibility required to analyze incurred costs to date versus projections of where they should be. Concerning format, it should facilitate the review process by providing all the required data in a clear and concise fashion. However, it is suggested that to the degree that existing contractor generated reports will suffice, use them. Also, before agreeing upon the level and type of detail, as well as format, it is recommended you consult with DCAA in that you may need their further support as the rate year progresses.

Monitoring FPRAs

Reports

Depth of Detail

Caveat: Routinely requiring very detailed data can become very cumbersome, costly and superfluous. Also, it can unnecessarily delay the issuance and analysis of the reports. On the other hand, should you deem top level data to be ordinarily sufficient, it is suggested that the FPRA contain provisions to permit the ACO to request more detailed support when deemed necessary.

Monitoring FPRAs

Questioned Costs

Upon identification of unallowed or other questioned costs resulting from analysis of the reports, what action should the ACO pursue? Where the said costs are significant, it is suggested that a Notice of Intent to Disallow Costs be issued, rather than defer resolution until dispositioning final rate claims. To do so, precludes adverse impacts under future fixed priced contracts, and eliminates potential grounds to claim estoppel, regardless of contract type. In fixed priced situations, unless Defective Pricing, fraud, or the Cost Accounting Standards apply, the government is unable to retroactively recoup such costs.

Monitoring FPRAs

Continuous FPRAs

A continuous FPRA is one that includes provisions for continuous update. As such, the basic assumptions and methodologies are agreed upon and documented so as to accommodate for adjustments as required, including shifts in production or marked changes in the business base. Accordingly, it provides an alternative to cancellation in that the underlying assumptions and modeling remain applicable, even though rates will materially change in response to fluctuations in the business climate. In such cases, the ACO must notify customers of the potential impact of the change and separately negotiate the issue or issues impacted only, while all else remains the same.

Monitoring FPRAs

Continuous FPRAs

The obvious advantage of Continuous FPRAs is continuous rate coverage. On the down side, to establish one is costly in terms of commitment of resources in order to adequately address the myriad of variables. This commitment entails coordinating numerous personnel from diverse disciplines over a dedicated period of time. Accordingly, continuous agreements may be used most effectively for extremely large contractors subject to “should cost reviews.”

FPRAs

Need to Know or Closing The Loop

It is imperative that PCOs ... om...s be apprised of changes to proposed, recommended or agreed upon rates. Accordingly, the One Book dictates that ACOs and DACOs administering major weapon system contracts "…provide proposed and recommended Forward Pricing Rate information to the PCO and the DCMC Program Integrator," the PI, as well as the CACO. The PI is charged with incorporating the information into the monthly Program Assessment Report to be submitted to the program office.

Monitoring FPRAs

What They Need to Know

Whenever rates change or are expected to change, the information to be furnished through the PI should address significant aberrations in major rate pools, the causes, the corrective actions taken by the company,and the overall monetary impact to the program. Program costs should be developed with the EVMS Coordinator and contractor.

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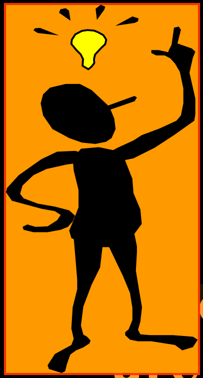
Other Considerations



Because assumptions and models for outlying years are less reliable where a FPRA addresses more than one accounting period, be especially attuned to trends in the general business economy, as well as those specific to the contractor, in order to discern changes that may possibly impact the later years. Talk to the Program Managers to understand long term programmatic needs. Secure year-end statements issued to stockholders to understand where the company has been, and where it is slated to go. Read newspapers and related business periodicals to identify current and upcoming trends and events.

Monitoring FPRAs

Other Considerations

Other than major accounting changes, such as restructures and mergers, probably the single most important variable, with its related set of assumptions, to be sensitive to is sales or revenues, and any changes thereto. Allocation bases, variable portions of semi-variable costs and variable expenses are derivatives thereof.

Monitoring FPRAs
Other Considerations

Other changes to be alert to during the course of business that may impact rates include: increases in capital investments to modernize or augment capacity, or decreases thereto; increases in IR&D to develop future product lines, or decreases thereto; shifts to or from human resources to automation, and/or subcontracts; alteration of supervisory ratios to become less top heavy, or to provide greater oversight; reorganizations; downsizing; acquisition of new product lines and companies; etc.

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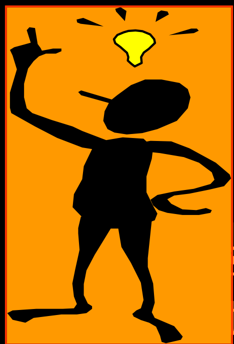
Other Considerations



Most importantly, cultivate good working relationships between all members of the government team, i.e., CACOs, DACOs, ACOs, Engineers, Pricers, Program Integrators, Industrial Specialists, Quality Assurance Specialists, as well as the auditors, the PCOs and Program Managers. The timely and effective sharing of information that may impact the rates is the responsibility of every team member. Accordingly, ACOs can consider the other team members as their extended eyes and ears. Ultimately the monitoring of rates is everyone's business, including that of the contractor.

Monitoring FPRAs

THE END